

# *The disclosure regime of credit rating agencies: an obscure veil of compliance?*

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Miglionico, A. ORCID: <https://orcid.org/0000-0002-2114-6709>  
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# The Disclosure Regime of Credit Rating Agencies. An Obscure Veil of Compliance?

Andrea Miglionico\*

## Abstract

Following the inaccurate evaluation of the default risk of certain financial products—such as subprime mortgages and derivatives—that affected the stability of securities markets, the reliability of credit rating agencies (CRAs) has been questioned. CRAs' activities have exhibited a lack of due diligence and deficiency in their assessment of corporations' creditworthiness. Moreover, this underscores the failings of the issuer-agency relationship that characterizes the ratings business model. This relationship is fraught with major conflicts of interest because the purposes of issuers with regard to their ratings often do not square with investors' need to receive reliable ratings information. This article argues that CRAs exhibit potential conflicts of interest because they have a financial incentive to accommodate the preferences of bond issuers owing to the fact that the rater is selected and paid by the issuer. This heavy dependence gives rise to ratings inflation and inaccuracy. What is crucial for the raters and, needless to say, the markets is to increase the quality of publicly available information before it is used in a rating assessment.

Keywords: reputational intermediaries, rating methodologies, information disclosure, compliance function, conflicts of interest, 'issuer-pays' business model, risk-based supervision, investor protection.

## 1. *Setting the scene of CRAs*

Credit rating agencies (CRAs) tend to be cast in the role of watchdogs of securities on account of their function in reducing information asymmetries between market participants.<sup>1</sup> At the very least, credit rating is a source of public information for investment decisions. However, CRAs are not supposed to measure a security's potential for price appreciation. They collect dispersed information on the financial position of borrowers and the default risk of certain products (e.g. derivatives, asset-backed securities, bonds, loans and commercial paper), and condense it into a single measure of relative credit risk. Credit ratings express risk

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\* Lecturer, University of Reading, School of Law. E-mail: a.miglionico@reading.ac.uk. The author wishes to thank Prof Rodrigo Olivares-Caminal, Dr Andromachi Georgosouli, Dr Miriam Goldby and Dr Andreas Kokkinis for their stimulating conversations and insightful thoughts on a preliminary version of this article. The author is grateful to the anonymous reviewer for the useful comments provided on an early draft. Any errors or omissions remain the sole responsibility of the author.

<sup>1</sup> Bruce G. Carruthers, 'From uncertainty toward risk: the case of credit ratings' (2013) 11(3) *Socio-Economic Review*, 530. It is observed that the function of CRAs to mitigate the uncertainty in credit markets—by managing the information asymmetries between lenders and borrowers—has evolved into a key component of global financial governance. As a result, credit ratings began to govern the allocation of trade credit, consumer credit, mortgage credit, small business credit, corporate credit and even sovereign credit.

in relative rank order and are not predictive of a specific frequency of default or loss.<sup>2</sup> Elaborating credit analysis, CRAs use the terms “investment grade” and “speculative grade” to describe the categories ‘AAA’ to ‘BBB’ (investment grade) and ‘BB’ to ‘D’ (speculative grade). The term “non-investment grade” or “speculative grade” generally refers to debt securities where the issuer currently has the ability to repay but faces significant uncertainties, e.g. adverse business or financial circumstances that could affect credit risk.<sup>3</sup> As stated by the one of the leading CRAs, ‘credit ratings are designed primarily to be our forward-looking opinions about creditworthiness and unlike other types of opinions, such as, for example, those provided by doctors or lawyers, credit ratings opinions are not intended to be a prognosis or recommendation’.<sup>4</sup> There is no doubt that CRA intends its ratings to be an ‘opinion’ but it is useful to understand whether the intention of the CRA is of any relevance in determining the legal nature of a rating.

This article examines the business model of CRAs considering the system of disclosure of ratings and its interplay with the supervisory articulation introduced by the European Securities and Markets Authority (ESMA).<sup>5</sup> The evidence now emerging on ESMA’s powers on CRAs’ activities suggests that the normative framework has been effective after the implementation of 2013 CRA Regulation.<sup>6</sup> Section two offers an overview of the role of CRAs and the applicable regulatory regime in the ratings industry. Section three provides an analysis of the main issues that affect reliability of the solicited and unsolicited ratings. It can be noted that the solicited services show a close relationship between issuers and raters which results in dubious practices to the benefit of investors. The unsolicited services highlights the opacity of the rating process in the absence of issuer input and unclear access to public information. Section four considers the information system of CRAs and the potential risks of

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<sup>2</sup> There are three types of credit rating ‘scales’: (1) the fundamental ordinal scale which is used by CRAs to position the creditworthiness of an issuer or instrument; (2) financial market credit spreads, which result from the investment decisions of bond investors; and (3) market-implied credit ratings, which are derived from a combination of mathematical modeling of the arbitrage equilibrium prices of an issuer’s equity and assets, probability theories and empirical observations of past defaults.

<sup>3</sup> Therefore, the terms “investment grade” and “speculative grade” are used as market conventions. Investment grade categories indicate relatively low to moderate credit risk, while ratings in the “speculative” categories either signal a higher level of credit risk or that a default has already occurred. See Iain MacNeil, ‘Credit rating agencies: regulation and financial stability’ in Thomas Cottier, Rosa M. Lastra and Christian Tietje (eds), *The Rule of Law in Monetary Affairs* (Cambridge: CUP 2014) 179.

<sup>4</sup> Standard & Poor’s, ‘Guide to Credit Rating Essentials. What are credit ratings and how do they work?’ (2011), available at [www.standardandpoors.com](http://www.standardandpoors.com).

<sup>5</sup> Regulation No 513/2011 designated ESMA as the single supervisor of credit rating agencies within the EU. According to Regulation 1095/2010 of the European Parliament and Council, ESMA shall act within the powers conferred by its establishing Regulation and within the scope of EU Regulation 1060/2009/EC.

<sup>6</sup> European Securities and Markets Authority, ‘ESMA fines DBRS Ratings Ltd. for internal control failings’, ESMA/2015/1050, 29 June 2015.

faulty ratings. It is suggested that the lack of transparency brings about an imbalance of information between parties to trade (one so severe that exchange is impeded). It is manifest that the party with superior information (rating agency) relating to the probability of default can opportunistically use it to induce the other party (issuer) into unexpected and undesired outcomes. The importance of sound validation techniques for rating models stems from the proposition that poor quality assessments could lead to sub-optimal financial products allocation. Section five discusses the problem of conflicts of interest by providing a critical appraisal of the limitations of CRAs' compliance function for reviewing and monitoring methodologies. Policymakers are primarily relying on the procedures a CRA has in place for managing issuers' information. Consequently, investors should be able to evaluate the risk that a published rating is compromised by the disclosed conflict. The last section draws some concluding observations.

## 2. *The role of CRAs and the applicable regulatory framework*

The usefulness of a CRA is dependent upon its reliability in making assessments and public acceptability.<sup>7</sup> These two elements, i.e. reliability and acceptability, reflect the fact that market participants use the ratings of the three leading CRAs (Standard & Poor's, Moody's Investors Service and Fitch) because the market trusts their ratings and participants know that other players will also accept their evaluations.<sup>8</sup>

Once they have issued a rating, CRAs maintain oversight over issuers and their securities, and investors are informed through the rating report when changes affect issuers and financial products.<sup>9</sup> Despite the CRAs' claims of scrutiny, the changes in ratings do not seem to be related to changes in the individual probabilities of default of the rated firms.<sup>10</sup> The internal models used to formulate the ratings are based on confidential information passed by the issuer rather than being the outcome of CRAs' due diligence. The risk of ratings volatility lies behind the fact that issuers are more willing to get a 'triple-A' for gaining access to capital

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<sup>7</sup> Reiner H. Kraakman, 'Gatekeepers: The Anatomy of a Third-Party Enforcement Strategy' (1986) 2(1) *Journal of Law, Economics, and Organization*, 54.

<sup>8</sup> Carsten Thomas Ebenroth and Thomas J. Dillon, Jr., 'The International Rating Game: An Analysis of the Liability of Rating Agencies in Europe, England, and the United States' (1993) 24(3) *Law & Policy in International Business*, 783.

<sup>9</sup> David Ramos Muñoz, *The Law of Transnational Securitization* (Oxford: OUP 2010) 263, where it is observed that 'ratings are crucial to determine the regulatory capital required for an investment. For that reason, reliability of rating agencies is vital'.

<sup>10</sup> Paulo Viegas de Carvalho, Paul Anthony Laux and João Pedro Pereira, 'The stability and accuracy of credit ratings' (2014) 34-36, available at <http://ssrn.com/abstract=2504972>. According to the 'accuracy ratio' indicator to evaluate the performance of a rating system, it is documented that ratings are not "through-the-cycle", particularly CRAs have more volatile ratings during bad economic times.

markets and selling their products. In this way, rating updates appear an advertising tool to attract bond investors to lend to firms rated by CRAs and, at the same time, a disincentive for investors to conduct their own assessment on securities. In other words, rating changes seem driven by economic targets—such as marketing the profitable ‘opinion’—rather than information motives. It is questionable whether rating maintains accuracy and stability of the public grades provided to financial markets since there are no internal written policies and procedures in the CRAs to address the opacity of their methodologies.<sup>11</sup>

Rating methodologies evolve over time and continue to be adjusted in response to new information and economic developments. These adjustments tend to be small, and CRAs are generally careful to keep the number of rating changes triggered by these adjustments to a minimum although there are some methodological differences among the big three CRAs, their ratings do track each other very closely. Rating methodologies refer to the methods and processes that govern CRAs’ application of criteria to a particular rating or practice i.e. corporate, public finance, asset-backed securities.<sup>12</sup> When assigning and monitoring ratings, CRAs use financial statements, information about the issuer, industry and market condition although the related weights of these factors utilized in determining a rating are not publicly disclosed.<sup>13</sup> This can affect the expectations of investors about the creditworthiness of firms and the risks of unexpected default. In the Enron failure, gatekeepers certified the issuer’s compliance with an inventory of highly technical rules—without the auditor necessarily taking responsibility for the overall accuracy of the issuer’s statement of its financial position.<sup>14</sup>

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<sup>11</sup> Securities and Exchange Commission, ‘2015 Summary Report of Commission Staff’s Examinations of Each Nationally Recognized Statistical Rating Organization’, December 2015, 18-20. See also Nan S. Ellis and Steven B. Dow, ‘Attaching Criminal Liability to Credit Rating Agencies: Use of the Corporate Ethos Theory of Criminal Liability’ (2014) 17(1) *University of Pennsylvania Journal of Business Law*, 169.

<sup>12</sup> Standard & Poor’s, ‘Methodology: Credit Stability Criteria’ (2011), available at [www.standardandpoors.com/ratingsdirect](http://www.standardandpoors.com/ratingsdirect); Moody’s Investors Service, ‘Rating Symbols and Definitions’, August 2014, 5; Fitch Ratings, ‘Definition of Ratings and Other Forms of Opinion’, January 2014, 9-10. It is generally considered that the key methods to measure the creditworthiness (or likelihood of default) of an issuer or an obligation are the ‘probability of default’ and the ‘recovery rate’. The “probability of default” measures the relative default risk of an issuer and is based on the probability of occurrence of a delayed payment of interest or principal on any financial obligation. The “recovery rate” is measured by the recovery rating, an evaluation that indicates the uncertainty of the recovery prospects when default has occurred. Beyond the likelihood of default other important factors are: (1) the payment priority of an obligation following default; (2) the projected recovery that an investor would expect to receive if an obligation defaults; and (3) the credit stability. An example would be the specific quantitative measures that CRAs use to assess current and future cash flows and the ability to cover expected interest expense for issuers in specific industry sectors.

<sup>13</sup> IOSCO, ‘The role of Credit Rating Agencies in structured finance markets. Final Report’ (May 2008) 9-10. See also Securities and Exchange Commission, ‘Summary Report of Issues Identified in the Commission Staff’s Examinations of Select Credit Rating Agencies’, July 2008, 13-15.

<sup>14</sup> John C. Coffee Jr., ‘Understanding Enron: “It’s About the Gatekeepers, Stupid” (2002) 57(4) *The Business Lawyer*, 1416.

At the international level, the IOSCO Code of Conduct Fundamentals for Credit Rating Agencies of 2015 provides a set of guidelines and practical measures for implementing the governance of ratings industry aiming at enhancing transparency of information.<sup>15</sup> The IOSCO measures intend to address the following objectives: (1) quality and integrity of the credit rating process; (2) CRA independence and the avoidance of conflicts of interest; (3) CRA responsibilities to the investing public, rated entities, obligors, underwriters and arrangers; (4) risk management and employee training; and (5) disclosure and communication with market participants. The Basel III Accord has confirmed that the IOSCO Code of Conduct is the international benchmark for CRAs' rules of conduct. Under the Basel III rules, national supervisors should refer to the IOSCO Code when determining External Credit Assessment Institution (ECAI) eligibility.<sup>16</sup> As stated by the Basel Committee, 'external ratings that can be used for the capital purposes, according to the Basel II framework, are limited to the ratings provided by recognized ECAIs'.<sup>17</sup>

ECAIs play an important function in the regulatory standards of capital requirements<sup>18</sup> and in setting capital models for credit risk.<sup>19</sup> The Basel Committee affirmed that rating systems are the cornerstone for the calculation of banks' regulatory capital according to the 'internal ratings-based approach' of Basel II.<sup>20</sup> In this view, ECAI recognition provides a basis for risk-weighted capital requirements calculations under the 'Standardized Approach'<sup>21</sup> and 'Securitization Ratings Based Approaches'.<sup>22</sup> Such approaches are designed to increase

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<sup>15</sup> IOSCO, 'Code of Conduct Fundamentals for Credit Rating Agencies', FR05/2015, March 2015, 3, available at <https://www.iosco.org/library/pubdocs/pdf/IOSCOPD482.pdf>.

<sup>16</sup> Basel Committee on Banking Supervision, 'Basel III: A global regulatory framework for more resilient banks and banking systems', June 2011, 52. The European Central Bank (ECB) has defined an external credit assessment institution (ECAI) as 'an institution whose credit assessments may be used by credit institutions for determining the risk weight of exposures in accordance with the Capital Requirements Directive'. See ECB, 'The Implementation of Monetary Policy in the Euro Area', September 2006, 45.

<sup>17</sup> Basel Committee on Banking Supervision, 'Stocktaking on the use of credit ratings', The Joint Forum, June 2009, 19.

<sup>18</sup> Especially in the so-called pillar I 'Minimum Capital Requirements' of Basel II. See Basel Committee on Banking Supervision, 'International Convergence of Capital Measurement and Capital Standards', June 2006, 27-29.

<sup>19</sup> Under Basel II, banks used ratings assigned by recognized CRAs in determining credit risk weights for many of their institutional credit exposures. See Kern Alexander, 'Bank capital regulation and the role of external ratings: Unresolved issues' in Jan Kleineman, Lars Gorton and Aron Verstandig (eds), *Perspectives on Credit Rating Agencies* (Stockholm: Författarna, Stockholm Centre for Commercial Law Jure Förlag AB 2013) 235-236.

<sup>20</sup> Basel Committee on Banking Supervision, 'Studies on the Validation of Internal Rating Systems', Working Paper No 14, May 2005, 7.

<sup>21</sup> Under the 'standardized approach', banks that engage in less complex forms of lending and credit underwriting and that have simpler control structures may use external measures of credit risk to assess the credit quality of their borrowers for regulatory capital purposes. See Kern Alexander, 'The Risk of Ratings in Bank Capital Regulation' (2014) 25(2) *European Business Law Review*, 302.

<sup>22</sup> Under the 'Securitization Ratings Based Approaches', banks must apply the securitization framework for determining regulatory capital requirements on exposures arising from traditional and synthetic securitizations

the risk sensitivity of capital requirements for banks. The regulation of ECAIs was incorporated into EU legislation through the Capital Requirements Directive (CRD)<sup>23</sup> that established for the first time a framework of recognition of CRAs as ECAIs by competent European authorities.<sup>24</sup>

ECAI's activities raise the issue of 'how important it is for external rating agencies to retain credibility by posting ratings for bank loans that will prove to be ex post accurate'.<sup>25</sup> In this context, ECAIs' performance has come under fire for their handling of the 2007-09 financial crisis when they failed adequately to assess the risk associated with securitization exposures. The crisis has demonstrated that external credit ratings did not adequately reflect the risk of certain structured finance asset classes such as mortgage backed securities and resecuritization positions of an underlying transaction.<sup>26</sup> The growing demand for rating services, which has been driven by the advent of new financial products, has also contributed to ECAIs being more in the spotlight.<sup>27</sup> The banks, which were creating asset-backed securities and products based on them, paid ratings agencies to rate securitized instruments in order to improve their marketability to investors.<sup>28</sup>

The inadequacy of Basel II provisions for the purpose of preventing banks from reducing their capital charges by pooling loans in off-balance-sheet vehicles gave rise to significant changes through the new Basel III Accord.<sup>29</sup> Paragraph 121 of the Accord states that 'banks

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or similar structures that contain features common to both. See Kern Alexander, Rahul Dhumale and John Eatwell, *Global Governance of Financial Systems: The International Regulation of Systemic Risk* (Oxford: OUP 2006) 41.

<sup>23</sup> Directive 2006/48/EC of the European Parliament and of the Council of 14 June 2006 relating to the taking up and pursuit of the business of credit institutions (OJ 2006 L 177, p. 1). The Directive has been replaced by Directive 2013/36/EU on access to the activity and the prudential supervision of credit institutions and investment firms—Capital Requirements Directive IV (OJ 2013 L 176, p. 338). Recital 73 in the preamble to the Capital Requirements Directive IV states that 'the recognition of a credit rating agency as an external credit assessment institution (ECAI) should not increase the foreclosure of a market already dominated by three undertakings. EBA, the Member States' central banks and the ECB, without making the process easier or less demanding, should provide for the recognition of more credit rating agencies as ECAIs in order to open the market to other undertakings'.

<sup>24</sup> See Annex VI, Part 3, para 1 to Directive 2006/48/EC.

<sup>25</sup> Patrick Honohan, 'Perverse Effects of a Ratings-Related Capital Adequacy System', World Bank, Policy Research Working Paper Series No 2364, 2000, 2.

<sup>26</sup> Basel Committee on Banking Supervision, 'The Proposed Revised Ratings-Based Approach', Working Paper No 23, January 2013, 3. The Basel Committee clarified that 'the underlying transaction is a 'resecuritisation where the pool contained at least one tranching exposure'.

<sup>27</sup> Basel Committee on Banking Supervision, 'Revisions to the Basel Securitisation Framework', Consultative Document, December 2012, 4. The paper states that the emphasis placed on credit ratings within the Basel securitization framework resulted in rating agency errors flowing through to regulatory capital requirements.

<sup>28</sup> Julia Black, 'Forms and Paradoxes of Principles Based Regulation' LSE Law, Society and Economy Working Papers 13/2008, 10.

<sup>29</sup> Basel Committee on Banking Supervision, 'Basel III: A global regulatory framework for more resilient banks and banking system', December 2010 (rev June 2011) 52-53. For an academic view see Markus K. Brunnermeier, 'Deciphering the Liquidity and Credit Crunch 2007-2008' (2009) 23(1) *Journal of Economic*

will not be allowed to “cherry-pick” the assessments provided by different ECAIs and arbitrarily change the use of ECAIs’.<sup>30</sup> Under the Basel II framework, banking regulators allowed banks to use credit ratings from approved ECAIs when setting their capital requirements.<sup>31</sup> Although this has been at least mitigated by Basel III, as long as banks are permitted to make extensive use of ratings for capital adequacy purposes, their internal rating scales will continue to be dependent on the ECAIs’ statements.<sup>32</sup>

At the EU level, Regulation No 1060/2009 has been amended by Regulation No 462/2013 (‘2013 CRA Regulation’)<sup>33</sup>—a legislative act accompanied by Directive No 14/2013<sup>34</sup>—that imposes significant obligations on credit rating agencies. The 2013 CRA Regulation addresses major concerns of the governance of CRAs such as the limited competition in the ratings industry and the ‘issuer-pays’ business model. The main rationale behind the enactment of this legislation is mainly to reduce conflicts of interest and enhance disclosure of ratings process. The 2013 CRA Regulation aims to ensure that ‘modifications to the rating methodologies do not result in less rigorous methodologies’. Article 8(2) of 2013 CRA Regulation requires credit ratings and rating outlooks to be subject on a thorough analysis of all the information available.<sup>35</sup> However, ‘the real problem is that the agencies’ mathematical formulas look backward while life is lived forward, that is unlikely to change’.<sup>36</sup> The determination of credit ratings involves subjective judgment. The problem is made worse by the fact that investors find it difficult to choose the right financial product because there is no appropriate system of disclosure within CRAs.

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*Perspectives*, 81; see also Emily Lee, ‘The soft law nature of Basel III and international financial regulations’ (2014) 29(10) *Journal of International Banking Law and Regulation*, 605-606.

<sup>30</sup> Basel Committee on Banking Supervision (note 27) 54.

<sup>31</sup> John Authers, ‘Who will teach responsibility in a buck-passing world?’ *Financial Times* (London, 22 June 2014). It is pointed out that ‘the “Basel II” bank regulations gave investors a big incentive to buy anything stamped triple A by agencies. Ratings were only ever advertised as opinions, based on publicly available information: the agencies fell short when investment banks started trying to persuade them that products based on subprime mortgages should be rated triple A’.

<sup>32</sup> Angus Duff, ‘The credit ratings agencies and stakeholder relations: issues for regulators’ (2009) 24(1) *Journal of International Banking and Financial Law*, 11.

<sup>33</sup> Regulation (EU) No 462/2013 of the European Parliament and of the Council of 21 May 2013 amending Regulation (EC) No 1060/2009 on credit rating agencies (OJ 2013 L 146 p. 1).

<sup>34</sup> Directive 2013/14/EU of the European Parliament and of the Council of 21 May 2013 amending Directive 2003/41/EC on the activities and supervision of institutions for occupational retirement provision, Directive 2009/65/EC on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS) and Directive 2011/61/EU on Alternative Investment Fund Managers in respect of over-reliance on credit ratings (OJ 2013 L 145 p. 1).

<sup>35</sup> Article 8(2) of Regulation (EU) No 462/2013. The provision states that ‘credit rating agencies shall adopt all necessary measures so that the information it uses in assigning credit ratings and rating outlooks is of sufficient quality and from reliable sources’.

<sup>36</sup> Roger Lowenstein, ‘Triple-A Failure. The Ratings Game’, *The New York Times* (New York, 27 April 2008).



### 3. *The solicited ratings*

Solicited ratings characterize the ‘issuer-pays’ business model in which CRAs are directly paid by their principals (i.e. companies, investment banks).<sup>37</sup> In this situation, potential conflicts of interest could arise because of possible collusive actions in the agencies’ relationship.<sup>38</sup> Since the rating fee is paid by the principal, the issuer may be able to influence the rating obtained by threatening to use another agency or none if the rating assigned by the agency is too low. As Kaufman noted, ‘CRAs can be subject to reputational costs when they engage in inappropriate rating actions: in this regard, disclosure rules help to break the entry barrier for smaller rating agencies with strong performance records in a market that is dominated by the main CRAs’.<sup>39</sup> A major function of CRAs is to certify to relatively uninformed traders that they do not face a significant informational disadvantage, though most clients of CRAs are sophisticated (such as investment banks, alternative investment funds and sovereign wealth funds).<sup>40</sup> However, asymmetries in the market for reputational intermediaries hamper their ability to play this role.<sup>41</sup>

In conducting their analysis, CRAs may obtain non-public information—such as credit agreements, acquisition agreements and private placement memoranda—that is often provided pursuant to a confidentiality agreement between the rating agency and the issuer, or is provided premised upon the rating agency’s policy to keep such information confidential. It can be observed that the issuer needs to invest time and resources in producing the necessary information to the CRA on a timely basis.<sup>42</sup> Managers and raters are often involved in the ratings process and participate in fees discussions. Such a model has the potential for conflicts of interest since the entities are paying for the rating.<sup>43</sup>

In *Wingecarribee Shire Council v Lehman Brothers Australia Ltd (in liquidation)*, the court held that the CRA had breached the fiduciary duties it owed with respect to local

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<sup>37</sup> Lawrence J. White, ‘The Credit Rating Agencies’ (2010) 24(2) *Journal of Economic Perspectives*, 215.

<sup>38</sup> Tobias Johansson, ‘Regulating credit rating agencies: The issue of conflicts of interest in the rating of structured finance products’ (2010) 12(1) *Journal of Banking Regulation*, 4-5.

<sup>39</sup> George G. Kaufman, ‘The financial turmoil of 2007-20XX: causes, culprits and consequences’ in John Raymond Labrosse, Rodrigo Olivares-Caminal and Dalvinder Singh (eds), *Financial Crisis Management and Bank Resolution* (London: Informa 2009) 4.

<sup>40</sup> Dion Bongaerts, K. J. Martijn Cremers and William N. Goetzmann, ‘Multiple Ratings and Credit Spreads’ (2009) National Bureau of Economic Research, Working Paper Series No 15331, available at <http://www.nber.org/papers/w15331>.

<sup>41</sup> Bernard S. Black, ‘The Legal and Institutional Preconditions for Strong Securities Markets’ (2001) 48(4) *UCLA Law Review*, 788.

<sup>42</sup> Angus Duff and Sandra Einig, ‘Debt Issuer: Credit Rating Agency Relations and the Trinity of Solicitude: An Empirical Study of the Role of Commitment’ (2015) 129(3) *Journal of Business Ethics*, 557.

<sup>43</sup> Aline Darbellay, *Regulating Credit Rating Agencies* (London: Edward Elgar 2013) 9. It is observed that ‘the core of the problem lies in the tension between the CRA business model and the use of ratings as a regulatory tool’.

councils—as their investment adviser—by recommending products from which agency would receive significant fees and profits and that its conduct amounted to a breach of an Australian-specific consumer protection prohibition on misleading or deceptive conduct.<sup>44</sup> The scenario is further complicated as the CRAs do not owe any duty of care to investors due to the absence of contractual relationship. In cases of statements leading to pure financial loss there is a requirement for assumption of responsibility for a duty of care to arise, so it normally does not arise when there is no contractual relationship.<sup>45</sup> The Federal Court of Australia in *ABN AMRO Bank NV v Bathurst Regional Council*<sup>46</sup> and the U.S. Court of Appeals for the First Circuit in *Federal Home Loan Bank of Boston v. Moody's Corp. et al.*<sup>47</sup> recognized the fraudulent conduct of the CRAs in providing faulty ratings. These judicial decisions brought to light the vulnerability of rating methodologies, showing that credit ratings could not be considered a trusty benchmark of the quality of financial products.

The anomalies of rating methodologies are made worse by the fact that in the ‘issuer-pays’ business model, conflicts of interest may induce biased ratings with the result of tainted information to investors. It can be a problem of incomplete disclosure of information from the issuer since the market incentive for companies is to push CRAs for highest assessed financial products.<sup>48</sup> For instance, the rating process for structured financial products such as asset backed securities involves complex models based on mathematical and statistical methodologies that are not disclosed due to internal policies.<sup>49</sup> However, solicited ratings are

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<sup>44</sup> *Wingecarribee Shire Council v Lehman Brothers Australia Ltd (in liquidation)* [2012] FCA 1028. The Federal Court of Australia held that Lehman Brothers Australia, which was called Grange Securities Ltd (Grange), was an investment adviser that owed to the Councils fiduciary duties. The credit rating agency represented that its products—synthetic collateralised debt obligations (‘SCDOs’)—were prudent, capital protective investments and that they complied with statutory and Council policy requirements. Further, the Court found that the SCDOs did not have the characteristics that Grange promised to the Councils they would have in their individual contracts: that is, the SCDOs did not have a high level of security for the invested capital, were not easily tradeable on an established secondary market or able to be readily liquidated for cash and were not suitable investments for risk averse Councils.

<sup>45</sup> *Caparo Industries Plc v Dickman* [1990] 2 AC 831. The court held that there will be no liability in tort for negligent misrepresentation unless the maker of the statement knew that the statement would be communicated to the person relying on it specifically in connection with a particular transaction or a transaction of a particular kind. The limitation of a liability regime in the presence of sufficient proximity between the auditors and the shareholder is made clear in *Stone & Rolls v Moore Stephens* [2009] 1 A.C. 1391, where the House of Lords held that a wider remit of care was owed to creditors.

<sup>46</sup> *ABN Amro Bank NV v Bathurst Regional Council* [2014] FCAFC 65.

<sup>47</sup> *Federal Home Loan Bank of Boston v. Moody's Corp. et al.*, U.S. Court of Appeals No. 14-2148 (1st Cir. 2016).

<sup>48</sup> Robert J. Rhee, ‘Why Credit Rating Agencies Exist’ (2015) 44(2) *Economic Notes*, 167. It is observed that ‘there is a problem of coordination as to how much research and resources each firm should provide, resulting in a problem of free-riding and efforts to police it’.

<sup>49</sup> Standard & Poor’s provides a ‘Model Governance’ for regulating ‘Covered Models’ (Rating Models, Criteria Models, Market Intelligence Models and Ratings Services External Models): use of ‘Covered Models’ is governed by the Model Use Policy. See Standard & Poor’s, ‘Model Governance’, 15 June 2015 (restricted document).

subject to other concerns relating to ‘shopping for raters’. Rating shopping generally refers to ‘a situation in which a firm arranges for several CRAs to rate its forthcoming bond issue, but only discloses the most favorable rating’.<sup>50</sup> These concerns are related to the strategic behavior of principal and agent.<sup>51</sup> In the case of ‘rating shopping’ issuers move from one rating agency to another until they get a favorable rating.<sup>52</sup>

Big companies might shop for the highest ratings on their lucrative issuance deals, including playing one CRA against another when informally consulting them on structures to achieve high ratings.<sup>53</sup> As Bai claimed, ‘rating agencies that give out lower ratings risk their ratings not being selected and thus losing revenue to their less honest peers’.<sup>54</sup> This determines lack of competition and huge barriers for new entrants. By contrast reduced competition in this case might be good for accuracy as more competition could lead to more ‘CRA shopping’ by issuers as they will have more options to choose from ratings industry. In the case of a new CRA a single fee-paying issuer may comprise a large portion of the CRA’s overall revenue, creating a potential conflict of interest that may influence its rating decisions should the new entrant fear a loss of this business.<sup>55</sup>

As mentioned earlier, the ‘issuer-pays’ model may affect the ratings process through biased assessment because of the incentives for firms to influence the ratings in exchange of high fees.<sup>56</sup> In order to mitigate this problem, it is necessary to divorce issuer payment of the CRA from issuer selection of the CRA or encourage an alternative subscriber-pays market for ratings.<sup>57</sup> A system of standardized revenues could be put in place to reduce reliance on the

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<sup>50</sup> Tracy Alloway and Christopher Thompson, ‘Doubts raised over rating agency reform’ *Financial Times* (London, 11 June 2014).

<sup>51</sup> Andrew Cohen and Mark D. Manuszak, ‘Ratings Competition in the CMBS Market’ (2013) *Journal of Money, Credit and Banking*, Supplement to Vol. 45, No 1, 95-96.

<sup>52</sup> See on this point Steven Scalet and Thomas F. Kelly, ‘The Ethics of Credit Rating Agencies: What Happened and the Way Forward’ (2012) 111(4) *Journal of Business Ethics*, 482.

<sup>53</sup> Nicolette Kost de Sevres and Lorenzo Sasso, ‘The new European financial markets legal framework: a real improvement? An analysis of financial law and governance in European capital markets from a micro- and macro-economic perspective’ (2012) 7(1) *Capital Markets Law Journal*, 50.

<sup>54</sup> Lynn Bai, ‘On regulating conflicts of interest in the credit rating industry’ (2010) 13(2) *Journal of Legislation and Public Policy*, 263.

<sup>55</sup> IOSCO Technical Committee, ‘Report on the activities of credit rating agencies’ (September 2003) 14, available at <https://www.iosco.org/library/pubdocs/pdf/IOSCOPD153.pdf>.

<sup>56</sup> Frank Partnoy, ‘Rethinking regulation of credit-rating agencies: an institutional investor perspective’ (2010) 25(4) *Journal of International Banking Law and Regulation*, 195. An alternative business model is ‘fee-for-service style payment’ under which ‘if the credit-rating agency breached its arrangement with the issuer (for example, by ceasing its ratings or by changing its assumptions in a way that renders the ratings inaccurate), the issuer would no longer be obligated to pay the agency. Staggering pay in this way might avoid some of the perverse incentives in the ratings process’.

<sup>57</sup> Jonathan B. Cohn, Uday Rajan and Günter Strobl, ‘Credit Ratings: Strategic Issuer Disclosure and Optimal Screening’, Michigan Ross School of Business Working Paper No. 1214, November 2013, 3. It is argued that ‘a high rating allows the issuer to charge a higher price for its asset because it provides certification of the asset’s value’.

‘issuer-pays’ business model.

### 3.1 *The unsolicited ratings*

The second service, unsolicited ratings i.e. ratings that CRAs conduct without being formally engaged to do so by the issuer, is based on public rated activity in which CRAs are not paid by the issuer and conduct their assessment using publicly available information about the financial product.<sup>58</sup> According to S&P’s, ‘unsolicited ratings are those credit ratings assigned at the initiative of S&P’s and not at the request of the issuer or its agents’.<sup>59</sup> This type of rating is the subject of some controversy in the associated literature<sup>60</sup> although it seems clear that unsolicited ratings influence the markets and do at least reflect the level of public disclosure of the firms rated. CRAs may issue unsolicited ratings to force issuers to pay for ratings that they did not request.<sup>61</sup> What is more, unsolicited ratings are used as a way of establishing a track record before breaking into a new market.<sup>62</sup>

Unsolicited ratings have been described as simplistic and opportunistic activities. Empirical evidence has shown that unsolicited ratings tend to be lower than solicited ratings because of self-selection among issuers and the strategic conservatism of rating agencies.<sup>63</sup> This may happen because (1) there is no direct cooperation between issuers and raters and because of the incomplete or (2) low quality information in the hands of the ratings agencies. On this point, ‘firms that receive unsolicited ratings may feel obliged to request and pay for a solicited rating if they believe the unsolicited rating is too low and that its credit reputation has been tarnished’.<sup>64</sup>

Cantor and Packer argued that unsolicited ratings provide a powerful check against rating shopping and can affect the yield paid at issuance.<sup>65</sup> Other scholars observed that unsolicited

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<sup>58</sup> Sofya Abdurakhmanova, ‘Using Unsolicited Ratings to regulate the Credit Rating Agencies’ (2013) 18(2) *Fordham Journal of Corporate & Financial Law*, 471-473.

<sup>59</sup> Standard & Poor’s, ‘Standard & Poor’s Ratings Definitions’ (24 February 2012), available at <http://www.standardandpoors.com/ratings/articles/en/eu/?articleType=HTML&assetID=1245329361492>.

<sup>60</sup> Soku Byoun and Yoon S. Shin, ‘Unsolicited Credit Ratings: Theory and Empirical Analysis’ (2002) Working Paper, Financial Management Association Annual Meeting, 3-5.

<sup>61</sup> Lynn Bai (note 54) 264. The author observes that this happened in the leading case of *Jefferson County School Dist. No. R-1 v. Moody’s Investor’s Services, Inc.* [1999] No 97-1157.

<sup>62</sup> *ibid* 264-265.

<sup>63</sup> Christina E. Banner, Patrick Behr and Andre Güttler, ‘Rating Opaque Borrowers: Why Are Unsolicited Ratings Lower?’ (2010) 14(2) *Review of Finance*, 263-266. It is observed that ‘lower unsolicited ratings could simply be caused by a self-selection of high quality companies into the solicited rating status and of low-quality firms into the unsolicited (or no) rating status’.

<sup>64</sup> Abby Schultz, ‘Wake-up Call for the Rating Agencies’ (1991) 57 *The Investment Dealers Digest*, 18.

<sup>65</sup> Richard Cantor and Frank Packer, ‘The Credit Rating Industry’ (1994) 19(2) *Federal Reserve Bank of New York Quarterly Review*, 5.

ratings are biased downward in contrast to solicited ratings.<sup>66</sup> In this context, public disclosure not only appears to have a positive effect on CRAs but also seems to eliminate the downward bias of unsolicited ratings.<sup>67</sup> It can be argued that unsolicited ratings are lower (1) to ‘punish’ issuers who otherwise would not purchase ratings coverage or (2) because they are based only on public information and tend to be more conservative than solicited ratings. Further empirical studies find that there is a significant difference in the distributions of ratings because banks that have received shadow ratings are smaller and have weaker financial profiles than banks that have other ratings.<sup>68</sup>

A further area for analysis is whether unsolicited ratings are used to increase market share and extract payment from an unwilling issuer. CRAs tend to force companies to purchase their services with a view to making a profit. In addition, ‘an unsolicited rating is “feared” because it might put an issuer’s credit risk in a worse light than it actually is with the justification that it only reflects publicly available information’.<sup>69</sup> Unsolicited ratings may discourage new entrants from trying to build up a niche position because CRAs have traditionally been able to take advantage of economies of scale in ways that may inhibit entry for smaller competitors.<sup>70</sup>

The 2004 IOSCO Code of Conduct stated that ‘for each rating, the CRA should disclose whether the issuer participated in the rating process. Each rating not initiated at the request of the issuer should be clearly identified as such’.<sup>71</sup> The 2011 IOSCO Report affirmed in “CRA Principle Transparency and timeliness of ratings disclosure” that ‘CRAs should make disclosure and transparency an objective of their ratings activities’.<sup>72</sup> This principle is intended to promote the distribution of sufficient information regarding ratings procedures and methodologies owing to the risk of investor confusion in the issuance of unsolicited ratings. Consumer confusion arises when ratings do not merely represent additional valuable information about the financial products but lead to investor uncertainty and force companies

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<sup>66</sup> Winnie P.H. Poon, ‘Are unsolicited credit ratings biased downward?’ (2003) 27(4) *Journal of Banking & Finance*, 613.

<sup>67</sup> Patrick Van Roy, ‘Is there a difference between solicited and unsolicited bank ratings and if so, why?’ (2006) National Bank of Belgium Working Papers Research Series, 25, available at <http://www.nbb.be>.

<sup>68</sup> Winnie P.H. Poon and Michael Firth, ‘Are Unsolicited Credit Ratings Lower? International Evidence From Bank Ratings’ (2005) 32(9-10) *Journal of Business Finance & Accounting*, 1768.

<sup>69</sup> Fabian Dittrich, ‘The Credit Rating Industry: Competition and Regulation’ (2007) 110, available at <http://ssrn.com/abstract=991821>.

<sup>70</sup> Pragyant Deb, Mark Manning, Gareth Murphy, Adrian Penalver and Aron Toth, ‘Whither the credit ratings industry?’ Bank of England, Financial Stability Paper No 9, March 2011, 7.

<sup>71</sup> IOSCO Technical Committee, ‘Code of Conduct Fundamentals for Credit Rating Agencies’ (December 2004) 9.

<sup>72</sup> IOSCO Technical Committee, ‘Regulatory Implementation of the Statement of Principles Regarding the Activities of Credit Rating Agencies. Final Report’ (February 2011) 30-31.

to purchase their services.<sup>73</sup>

At the European level, the Commission recommended that disclosure requirements for solicited and unsolicited ratings should be strengthened by requiring CRAs to inform issuers for which they are in the process of issuing a rating sufficiently in advance of the publication of the rating.<sup>74</sup> It also included a requirement to elaborate on the main assumptions which justify the change of rating. The significant increase over time of references to credit ratings in rules and regulations—combined with scarce competition—has affected the business model of CRAs by creating a more or less ‘guaranteed market’ with few incentives to compete on the basis of rating quality.<sup>75</sup> CRAs provide their financial assessments to non-clients, i.e. unsolicited ratings, even if they have no access to the management or to internal due diligence of the firms concerned. In this way, CRAs rely solely on public data that may be different from the level of information disclosed by issuers, for instance unsolicited rating changes are not likely to convey information as much as solicited rating changes.<sup>76</sup>

#### 4. *The disclosure regime of CRAs*

Information disclosure represents a key aspect of CRAs’ activities. Generally, CRAs provide valuable information to those investors who have relatively limited information-gathering or analysis capacity and therefore cannot make credit evaluations as effectively as a rating agency. Those investors who do not have a direct negotiating relationship with the issuer. White argued that ‘credit rating firms can help lenders pierce the fog of asymmetric information that surrounds lending relationships. Equivalently, credit rating firms can help

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<sup>73</sup> Francis A. Bottini Jr, ‘An Examination of the Current Status of Rating Agencies and Proposals for Limited Oversight of Such Agencies’ (1993) 30(3) *San Diego Law Review*, 600.

<sup>74</sup> European Commission, Proposal for a Regulation amending Regulation (EC) No 1060/2009 on credit rating agencies and a Proposal for a Directive amending Directive 2009/65/EC on coordination on laws, regulations and administrative provisions relating to Undertakings for Collective Investment in Transferable Securities (UCITS) and Directive 2011/61/EU on Alternative Investment Fund Managers (15 November 2011) Commission Staff Working Paper, 180 (OJ 2011, L 174, p. 1). See also Regulation No 446/2012 of 21 March 2012 supplementing Regulation (EC) No 1060/2009 of the European Parliament and of the Council with regard to regulatory technical standards on the content and format of ratings data periodic reporting to be submitted to the European Securities and Markets Authority by credit rating agencies (OJ 2012, L 140, p. 2) and Regulation No 448/2012 supplementing Regulation (EC) No 1060/2009 of the European Parliament and of the Council with regard to regulatory technical standards for the presentation of the information that credit rating agencies shall make available in a central repository established by the European Securities and Markets Authority (OJ 2012, L 140, p. 17).

<sup>75</sup> John Kiff, Allison Holland, Michael Kisser, Sylwia Nowak, Samer Saab, Liliana Schumacher, Han van der Hoorn and Ann-Margret Westin, ‘The Uses and Abuses of Sovereign Credit Ratings’ in IMF World Economic and Financial Surveys. Global Financial Stability Report. Sovereigns, Funding and Systemic Liquidity (October 2010) 94.

<sup>76</sup> Soku Byoun, Jon A. Fulkerson, Seung Hun Han and Yoon S. Shin, ‘Are unsolicited ratings biased? Evidence from long-run stock performance’ (2014) 42 *Journal of Banking & Finance*, 327.

borrowers (and their credit qualities) emerge from that same fog'.<sup>77</sup> However, in contrast with this, poor due diligence, lack of research resources or lack of analytical resources and bona fide mistakes are the major criticisms leveled against the activities of the rating agencies.<sup>78</sup>

Well known financial scandals where the failure in ratings has been clearly evidenced (e.g. Enron, WorldCom and Lehman Brothers) have revealed the lack of due diligence and a deficiency in the evaluation of corporations' creditworthiness.<sup>79</sup> However, 'some of the disclosure failures reflected what may be the difficult reality of disclosing what must be, to a certain extent, a subjective process over a complex set of financial issues'.<sup>80</sup> These corporate failures are useful to illustrate the CRAs' abuses in respect of investor reliance as rating governance looked defective in terms of investor protection. In this context, CRAs should be subject to professional standards similar to those applicable to other information intermediaries—such as auditors and financial analysts—by recasting their responsibilities in order to put them under professional duties entailing the requisite degree of care vis-à-vis investors.<sup>81</sup>

It seems paradoxical that CRAs should be viewed as financial intermediaries intended to protect public investors when they enjoy a different regulatory treatment compared with other financial experts (auditors and financial analysts).<sup>82</sup> The US Dodd-Frank Act 2010 does not regard CRAs as 'investment advisers', although the value of credit ratings is recognized by the reference to liability standards similar to those applicable to other information

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<sup>77</sup> Lawrence J. White, 'The Credit Rating Industry: An Industrial Organization Analysis' (2002) 9 *The New York University Salomon Center Series on Financial Markets and Institutions*, 45-46.

<sup>78</sup> Marilyn Blumberg Cane, Adam Shamir and Tomas Jodar, 'Below Investment Grade and Above the Law: A Past, Present and Future Look at the Accountability of Credit Rating Agencies' (2012) 17(4) *Fordham Journal of Corporate & Financial Law*, 1072-1073.

<sup>79</sup> Tom Hurst, 'The role of credit rating agencies in the current worldwide financial crisis' (2009) 30(2) *Company Lawyer*, 62-64.

<sup>80</sup> Timothy E. Lynch, 'Deeply and Persistently Conflicted: Credit Rating Agencies in the Current Regulatory Environment' (2009) 59(2) *Case Western Law Review*, 266.

<sup>81</sup> Don A. Moore, Philip E. Tetlock and Lloyd Tanlu Max H. Bazerman, 'Conflicts of interest and the case of auditor independence: moral seduction and strategic issue cycling' (2006) 31(1) *Academy of Management Review*, 12. On the independence of auditors and their financial incentives regime see David Kershaw, 'Waiting for Enron: The Unstable Equilibrium of Auditor Independence Regulation' (2006) 33(3) *Journal of Law and Society*, 390.

<sup>82</sup> Generally, auditors preparing company accounts owe a duty of care to any person whom they ought reasonably to have foreseen might rely on the accounts. See *JEB Fasteners Ltd v Marks Bloom & Co* [1981] 3 All E.R. 289. This case showed that in absence of the necessary degree of proximity it is difficult to establish a duty of care between the parties. The principle that the auditor can owe the company an implied contractual duty of care for the inaccurate performance of the audit or may be accused of negligence and could potentially be liable for damages was also underlined in *Equitable Life Assurance Society v Ernst & Young* [2003] EWCA Civ 1114 and *Barings Plc v Coopers & Lybrand (No.7)* [2003] Lloyd's Rep I.R. 566 cases. In academic circles see Paolo Giudici, 'Auditors' multi-layered liability regime' (2012) 13(4) *European Business Organization Law Review*, 523-524; see also Michael Paterson, 'Reform of the law on auditors' liability: an assessment' (2012) 23(2) *International Company and Commercial Law Review*, 55; Alistair Alcock, 'House of Lords revisits auditors' liability' (2010) 5 *Journal of Business Law*, 453-454.

intermediaries.<sup>83</sup>

The imbalanced relationship between issuers and investors is principally determined by lack of financial knowledge and causes a distortion of consumers' choices, particularly at the time when the investment operation is executed.<sup>84</sup> To ensure rating accuracy, the market needs to achieve adequate disclosure protection in terms of reducing agency problems i.e. information asymmetries by improving the flow of price information. In other words, the market's judgment would represent the primary evidence of a rating activity, particularly through the assessment of information provided by firms. In this context, de Haan and Amtenbrink observed that 'while full disclosure of methodologies can contribute to a better understanding of the value of credit ratings, full disclosure could create strong disincentives to use the best available methodologies and to invest in better rating methodologies'.<sup>85</sup> However, full disclosure of rating methodologies can conflict with the efficient allocation of CRAs products as the internal models can be copied by other credit rating agencies. As a result, full disclosure of ratings criteria can be suboptimal because of free riding problem (i.e. all those who receive the information free of charge from the paying subscriber).<sup>86</sup> The reproduction and distribution to public of rating models would reduce the 'rating shopping' as well as the practice of biased assessments between issuer and rater.

Opportunistic behaviors by CRAs could be avoided by means of the compliance function, as a measure falling within the category of internal self-controls, which could limit the need to regulate by statute and reduce mandatory disclosure costs. It has been contended that 'compliance is, in principle at least, the result of a one-dimensional decision making process: individuals and businesses are self-interested utility maximizers who will comply with regulation if the probability of swift detection and sanction by the regulator in combination with the amount of the penalty outweighs the benefits of noncompliance'.<sup>87</sup> In this view, the effectiveness of the compliance function introduced by the 2013 CRA Regulation can allow

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<sup>83</sup> Allana M. Grinshteyn, 'Horseshoes and hand grenades: The Dodd-Frank Act's (Almost) Attack on Credit Rating Agencies' (2011) 39(4) *Hofstra Law Review*, 972-973. The author observed that 'although the statutory provisions creating a cause of action against credit rating agencies are likely to meet resistance in the courts, such provisions at the very least enhance the credit rating agencies' exposure to liability' (at 956).

<sup>84</sup> Alessio M. Paces, 'Financial intermediation in the securities markets, law and economics of conduct of business regulation' (2000) 20(4) *International Review of Law and Economics*, 499. The author claims that 'individual investors are, in fact, rationally ignorant in that they lack the information and the financial expertise necessary to engage in a knowledgeable evaluation of the quality of the services provided by intermediaries'.

<sup>85</sup> Jacob de Haan and Fabian Amtenbrink, 'Credit Rating Agencies', De Nederlandsche Bank Working Paper No 278, January 2011, 23.

<sup>86</sup> The concept of 'free-riding' was elaborated within the theory of public goods and it is defined as a situation in which an individual may be able to obtain the benefits of a good without contributing to the cost. See the classical work of James M. Buchanan, *The Demand and Supply of Public Goods* (Chicago: Rand-McNally 1968). See also E.C. Pasour Jr., 'The Free Rider as a Basis for Government Intervention' (1981) 5(4) *The Journal of Libertarian Studies*, 453.

<sup>87</sup> Christine Parker and Vibeke Lehmann Nielsen, 'Introduction: from regulation to compliance' in Christine Parker and Vibeke Lehmann Nielsen (eds), *Explaining Compliance. Business Responses to Regulation* (London: Edward Elgar 2011) 10.



action to be taken against behaviors amounting to misconduct and permit a sound system of risk management to be applied.

The US regulatory framework for Nationally Recognized Statistical Rating Organizations (NRSROs) requires mandatory disclosures be made by rating agencies as to their rating policies and methodology.<sup>88</sup> However, it involves very little direct oversight of the performance of an NRSRO to preventing or punishing poor performance. The US Securities and Exchange Commission (SEC) rules require disclosure of the rating agencies' policies regarding verification of underlying assets and information.<sup>89</sup> The usefulness of such general disclosures is likely to be limited because they could be written in a way that would allow a significant amount of deviation in the use of information and the extent of verification among similarly situated asset backed securities.<sup>90</sup> The purpose of these rules can be found first in the fact that they enhance the reputational cost to rating agencies that engage in inappropriate rating actions, and secondly that they help break the entry barrier for smaller rating agencies with strong performance records in a market that is dominated by the main CRAs.<sup>91</sup> Specifically, the disclosure rules aim: (1) to prohibit sales or marketing considerations to influence the development of the criteria for determining ratings; (2) to avoid forcing credit ratings to embody absolute probabilities of default; and (3) to require each rating agency to assign consistent meanings to its rating symbols across sectors.<sup>92</sup>

The 2013 CRA Regulation establishes a set of provisions imposing obligations on CRAs in connection with structured finance instruments. Article 10(1) of the CRA Regulation requires the credit rating agency to disclose 'any credit rating or rating outlook, as well as any decision to discontinue a credit rating, on a non-selective basis and in a timely manner'.<sup>93</sup> Further, CRAs are required to disclose the outcome of the annual internal review of its independent compliance function and financial information on the revenue of the credit rating

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<sup>88</sup> Kia Dennis, 'The Ratings Game: Explaining Rating Agency Failures in the Build Up to the Financial Crisis' (2009) 63(4) *University of Miami Law Review*, 1144.

<sup>89</sup> The SEC adopted in January 2011 Securities Exchange Act Rule 17g-7—pursuant to the Dodd–Frank Wall Street Reform and Consumer Protection Act—thereby imposing affirmative disclosure requirements on NRSROs when they issue credit ratings on asset-backed securities transactions. See Evan J. Cappelli, 'Credit Rating Agency Disclosure Requirements: A Guide to Rule 17g-7 Compliance When Rating Asset-Backed Securities' (2012) 25(6) *Journal of Taxation and Regulation of Financial Institutions*, 24.

<sup>90</sup> Dennis (note 88) 1145.

<sup>91</sup> Lynn Bai, 'The Performance Disclosures of Credit Rating Agencies: Are They Effective Reputational Sanctions?' (2010) 7(1) *NYU Journal of Law & Business*, 51.

<sup>92</sup> Securities and Exchange Commission, 'Nationally Recognized Statistical Rating Organizations', Release No. 34-72936, 79 Fed. Reg. 55078, 15 September 2014.

<sup>93</sup> Article 10(1) of the Regulation No 462/2013. See also Annex I, Section D to Regulation No 462/2013 where CRAs are required to disclose: (1) sources; (2) methodologies; (3) meaning; and (4) limitations of ratings and any limitations of data on which based.

agency.<sup>94</sup> ESMA identified several shortcomings related to the CRAs' internal governance: (1) the lack of quality controls over information used and received from data providers; (2) incomplete application of the full methodology during the rating monitoring process aggravated by insufficient disclosure of the different analytical frameworks used; (3) delays in the completion of the annual review of ratings; and (4) need to strengthen the role of the internal review function and the activities it performs during the review of methodologies, models and key rating assumptions applied to structured finance ratings in order to ensure effective independence from the business lines responsible for credit rating activities.<sup>95</sup>

When CRAs examine financial statements they 'rent out' their reputations for conducting a careful evaluation that can catch some fraud and discourage attempts at fraud, and for painting a tolerably accurate picture of a company's performance. In this case, liability risk reinforces the rating firm's concern for reputation and can persuade the CRA to establish internal procedures as to ensure transparency of financial statements. Disclosure rules could help, as do reputational intermediaries' incentives to advertise their successes.<sup>96</sup> However, financial intermediaries will not publicize their own failures, and investors will discount competitors' complaints on the ground that they come from a biased source.<sup>97</sup>

##### *5. Regulating the CRAs' conflicts of interest: a way towards compliance*

In the aftermath of the global financial crisis, CRAs were blamed to exacerbate the systemic risk because of their role in the financial markets as an information intermediary between investors and issuers.<sup>98</sup> As previously indicated, CRAs exhibit potential conflicts of interest because they have a financial incentive to accommodate the preferences of bond issuers owing to the fact that they are selected and paid by the issuers. This means ratings inflation and inaccuracy: issuers desire high ratings not necessarily accurate ratings.<sup>99</sup> The higher the securities rating, the less concern investors will have about payment default, the greater the liquidity and the lower the issuers' cost of capital. As a result, any investor who

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<sup>94</sup> European Securities and Markets Authority, 'Final Report on Draft Regulatory Technical Standards (RTS) under the CRA3 Regulation', 20 June 2014.

<sup>95</sup> European Securities and Markets Authority, 'Credit Rating Agencies. ESMA's investigation into structured finance ratings', ESMA/2014/1524, 16 December 2014, 4-5.

<sup>96</sup> Robert G. Eccles and Tim Youmans, 'Implied Materiality and Material Disclosures of Credit Ratings' (2015) Harvard Business School Working Paper 15-079, 15-16.

<sup>97</sup> Dawn-Marie Driscoll, W. Michael Hoffman and Joseph E. Murphy, 'Business Ethics and Compliance: What Management Is Doing and Why?' (1998) 99(1) *Business and Society Review*, 39.

<sup>98</sup> Andreas Kruck, 'Asymmetry in Empowering and Disempowering Private Intermediaries: The Case of Credit Rating Agencies' (2017) 670(1) *The ANNALS of the American Academy of Political and Social Science*, 144.

<sup>99</sup> Carol Ann Frost, 'Credit Rating Agencies in Capital Markets: A Review of Research Evidence on Selected Criticisms of the Agencies' (2007) 22(3) *Journal of Accounting, Auditing & Finance*, 478.

relies to any extent on ratings may be unknowingly bearing a risk for which they are not being compensated.<sup>100</sup>

Conflicts of interest may arise at both the individual rating analyst level and the rating agency level.<sup>101</sup> A related potential conflict arises in the context of underwriters attempting to influence the credit rating process. A large amount of bond offerings is underwritten by a few large firms, and the potential conflict exists for CRAs to rate a particular underwriter's clients more favorably in return for future business. The development of ancillary businesses—e.g. rating assessment, risk management and consulting services—provided by CRAs has increased the catalogue of conflicts. Prior to being issued with a public rating, issuers can purchase an 'indicative' or private rating, along with 'advice' regarding how the company might improve its rating. Therefore, the purchase of ancillary services could affect the credit rating decision, and issuers may be pressured into using them out of fear that their failure to do so could adversely impact their credit rating.

The growth of the credit derivatives market created the possibility that the use of credit ratings in counterparty collateral arrangements would produce a strongly pro-cyclical effect. This problem occurred in the case of the American Insurance Group company where derivatives were trading with the belief to provide safe collateral if the value of the insured securities reduced or if their own creditworthiness dropped.<sup>102</sup> As a result, the rapid increased of structured finance—mortgage-backed securities and collateralized debt obligations (CDOs)—produced massive and severe rating downgrades determined by the phenomenon of 'rating inflation'.<sup>103</sup> Ratings inflation was favored by the limited understanding of the risk of structured debt and by inaccurate information about the risk characteristics of the underlying assets.<sup>104</sup> As noted 'structured products are designed to take advantage of different investor

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<sup>100</sup> Daniel M. Covitz and Paul Harrison, 'Testing Conflicts of Interest at Bond Ratings Agencies with Market Anticipation: Evidence that Reputation Incentives Dominate' (2003) Federal Reserve Board Finance and Economics Discussion Series No 68, 1. The authors demonstrate that rating changes are not influenced by rating agency conflicts of interest but are instead motivated primarily by reputation-related incentives.

<sup>101</sup> Lynn Bai (note 54) 260. At the rating agency level, the author identifies the following potential conflicts of interest: affiliated underwriter or issuer; ancillary services to rated entities; large subscriber influence; and issuer-pay business model. These conflicts are regulated under the following main provisions: US Securities Exchange Act Rule 17g-5(c)(3), Rule 17g-5(c)(5), Rule 17g-5(b)(5), and Rule 17g-5(c)(1). Despite these rules the issuer-pays business model is not prohibited under the current regulatory regime.

<sup>102</sup> Financial Services Authority, 'The Turner Review. A regulatory response to the global banking crisis' (2009) 76. See also Navneet Arora, Priyank Gandhi and Francis A. Longstaff, 'Counterparty credit risk and the credit default swap market' (2012) 103(2) *Journal of Financial Economics*, 280-281.

<sup>103</sup> Marco Pagano and Paolo Volpin, 'Credit ratings failures and policy options' (2010) 25(62) *Economic Policy*, 413-415. It is noted that 'rating inflation benefits issuers only if at least some investors fail to take it into account in their investment decisions, either because they are naive or because their portfolio decisions are dictated by regulations prescribing investment in highly rated securities'.

<sup>104</sup> John M. Griffin and Dragon Yongjun Tang, 'Did Subjectivity play a Role in CDO Credit Ratings?' (2012) 67(4) *The Journal of Finance*, 1325-1326. See also Jérôme Mathis, James McAndrews and Jean-Charles

risk preferences; they are typically structured for each tranche to achieve a particular credit rating'.<sup>105</sup> CRAs knew little or nothing about the underlying assets backing the securitized structures they were rating.

Conflicts of interest may be exacerbated when CRAs involve the executive officers of companies to discuss the rating methodology or when CRAs permit issuers to submit the details of a proposed structure to them and then advise the issuer of their likely ratings.<sup>106</sup> Consequently, 'the rating agencies have a direct hand in defining the structure that a corporation must adhere to have the lowest possible cost of funding'.<sup>107</sup> CRAs showed conflicts of interest during the subprime mortgage crisis not only by giving their highest rating to most of the CDOs, but also by allowing issuers to consult raters on the design of the CDOs.<sup>108</sup> Clearly, the agency compensation arrangement constitutes on the face of it a per se conflict of interest. Another justification could be found in the manifest shortcomings in the CRAs' internal controls.<sup>109</sup>

As discussed in the solicited ratings, the central question is the issuer-agency relationship that characterizes the CRAs' business model. This relationship is faced with major conflict-of-interest questions because the interests of issuers in respect of their ratings often do not square with the need of investors to receive reliable ratings information.<sup>110</sup> In substance, conflicts arise: (1) when the issuer pays the rating agency evaluating the issuer's bonds; (2) when CRAs put in place consulting arrangements with the issuers of the bonds they rate; and (3) when CRAs take the incentive to set high fees for granting high ratings to their clients and a corresponding disincentive to downgrade.

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Rochet, 'Rating the raters: Are reputation concerns powerful enough to discipline rating agencies?' (2009) 56(5) *Journal of Monetary Economics*, 669; Patrick Bolton, Xavier Freixas and Joel Shapiro, 'The Credit Ratings Game' (2012) 67(1) *The Journal of Finance*, 109-110.

<sup>105</sup> Financial Stability Forum, 'Report of the Financial Stability Forum on Enhancing Market and Institutional Resilience', 7 April 2008, 33.

<sup>106</sup> Andrew Johnston, 'Corporate Governance is the problem, not the solution: A critical appraisal of the European regulation of credit rating agencies' (2011) 11(2) *Journal of Corporate Law Studies*, 409.

<sup>107</sup> Joshua Rosner, 'Toward an Understanding: NRSRO Failings in Structured Ratings and Discreet Recommendations to Address Agency Conflicts' (2009) 14(4) *The Journal of Structured Finance*, 9.

<sup>108</sup> Franklin Strier, 'Rating the Raters: Conflicts of Interest in the Credit Rating Firms' (2008) 113(4) *Business and Society Review*, 533. In commenting on the sub-prime mortgage' collapse, the author claims that 'greedy lenders offered adjustable rate loans with payments that they knew many of the home-buying borrowers probably could not afford' (at 534).

<sup>109</sup> European Securities and Markets Authority (note 95) 12-13. In this context, 'ESMA found that one or more CRAs do not ensure that information on the due diligence of the underlying assets, or alternatively the assessment performed by a third-party, is systematically requested and obtained for all transactions'.

<sup>110</sup> Charles W. Calomiris and Joseph R. Mason, 'Conflicts of Interest, Low-Quality Ratings, and Meaningful Reform of Credit and Corporate Governance Ratings' *Economic Policies for the 21st Century* (19 April 2010) 6. See also Charles W. Calomiris, 'The debasement of ratings: what's wrong and how we can fix it' *Economic Policies for the 21st Century* (26 October 2009) 10.

However, disclosure of rating services is not sufficient to ensure transparency in the bond rating. As ESMA observed, disclosure of each rating grade should be verified by independent bodies and not by the raters themselves.<sup>111</sup> Publicly available information should be managed by an external body to review the CRA’s compliance function independently before it is used in a rating report. This body would be separated from ‘modeling staff’ and would be responsible for the integrity of reporting lines. This would protect the reputation of the CRAs and increase investor confidence in the quality and objectivity of rating activities.

The intent to reduce the risk of analyst conflicts of interest and ensure the objectivity and quality of analyst ratings is the major challenge for regulators. The US Dodd–Frank Act of 2010 amended Section 15E(w) to prevent issuers, sponsors or underwriters of structured finance products from choosing the NRSRO that determine the initial credit ratings on such products.<sup>112</sup> This provision established the ‘Office of Credit Ratings’, a new organization that supports the SEC in supervising the NRSROs—the only CRAs allowed to determine initial credit ratings on structured finance products.<sup>113</sup>

At the EU level, Regulation (EU) No 462/2013 introduced specific rules aiming to reduce long-lasting relationships between rated entities and CRAs and to restore impartiality and independence of CRAs.<sup>114</sup> Article 6(1) of the 2013 CRA Regulation places an obligation on CRAs to ensure that credit ratings are not affected by any existing or potential conflicts of interest.<sup>115</sup> The rule sets out specific restrictions for a shareholder or a member of a credit rating agency that possesses at least five per cent of either the capital or the voting rights in that credit rating agency or in a company and has the power to exercise control or a dominant influence over that CRA.<sup>116</sup> CRAs are required to complete and publish an annual ‘transparency report’ containing detailed information about their legal structure and ownership, internal quality control systems, record-keeping policies, description of its

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<sup>111</sup> European Securities and Markets Authority, ‘Technical Advice. In accordance with Article 39(b) 2 of the CRA Regulation regarding the appropriateness of the development of a European creditworthiness assessment for sovereign debt’, ESMA/2014/850rev, 17 September 2014, 4-5 and 11-12. ESMA believes that external appeals lodged by a rated entity are an important part of the rating process. Further, ESMA requires that the persons involved in rating activities and the persons responsible for the annual review of methodologies be different. This is to ensure the independence of both activities.

<sup>112</sup> Section 15E(w) of the Securities Exchange Act of 1934 as added by Section 939D (“Initial Credit Rating Assignments”) of the Dodd-Frank Act of 2010.

<sup>113</sup> See <https://www.sec.gov/ocr/Article/ocr-about.html>.

<sup>114</sup> Recital 12 in the preamble to Regulation (EU) No 462/2013.

<sup>115</sup> Article 6, paragraph 4 of the Regulation (EC) No 462/2013 which requires that ‘credit rating agencies shall establish, maintain, enforce and document an effective internal control structure governing the implementation of policies and procedures to prevent and mitigate possible conflicts of interest and to ensure the independence of credit ratings, rating analysts and rating teams regarding shareholders, administrative and management bodies and sales and marketing activities’.

<sup>116</sup> Article 6(a) of the Regulation (EU) No 462/2013.

management and rating analyst rotation policy.<sup>117</sup> It is evident that the objective of the European legislator is to enhance transparency measures and to foster the reliability of the CRAs' rating methodologies.<sup>118</sup>

In this context, ESMA has adopted a risk-based approach to supervising CRAs and improving compliance with the provisions of the 2013 CRA Regulation.<sup>119</sup> ESMA's activities include formal requests for information, the conduct of inspections and investigations as well as the enforcement actions in appropriate cases (e.g. remedial action plan and the appointment of an Independent Investigating Officer).<sup>120</sup> However, supervision on CRAs' internal governance—clarity regarding staff roles and responsibilities, and the involvement of ratings analysts in business development—seems a difficult task for regulators.<sup>121</sup> This risk-based approach aims to enhance the oversight on CRAs and to improve the application of different supervisory tools such as the single Supervision Department, Ratings Data Reporting tool and the European Rating Platform. In this light, CRAs need to put in place effective compliance functions to ensure that these tools are adequately resourced.<sup>122</sup>

According to ESMA, 'compliance with a number of these points could not be demonstrated, typically because policies and procedures did not describe in sufficient detail

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<sup>117</sup> Regulation No 446/2012 (OJ 2012 L 140 p. 2), Regulation No 447/2012 (OJ 2012 L 140 p. 14), Regulation No 448/2012 (OJ 2012 L 140 p. 17) and Regulation No 449/2012 (OJ 2012 L 140 p. 32).

<sup>118</sup> Iris H-Y Chiu, 'Regulatory governance of credit rating agencies in the EU: the perils of pursuing the Holy Grail of rating accuracy' (2013) 4(2) *European Journal of Risk Regulation*, 209. It is observed that 'the EU Regulation places more emphasis on regulating for rating accuracy which has the effect of instituting a form of product regulation for credit ratings, raising the public interest profile of credit ratings', however 'this is undesirable and is contrary to policy-makers' endeavors to enhance market discipline for rating quality and the private accountability of credit rating agencies'.

<sup>119</sup> European Securities and Markets Authority, 'ESMA's supervision of credit rating agencies, trade repositories and monitoring of third country central counterparties', 3 February 2017, 7. It is underlined that 'ESMA adopts a risk-based approach to the supervision of credit rating agencies (CRAs) in accordance with its overall objectives of promoting financial stability and orderly markets and enhancing investor protection. In this context, ESMA launched the RATings DATA Reporting tool (RADAR) and the European Rating Platform (ERP). Through RADAR, CRAs are providing ESMA with information on credit ratings and pricing practices and fees charged for these credit ratings and ancillary services. The ERP provides access to free, up-to-date information on credit ratings and rating outlooks. The ERP complements the statistical data on CRAs' rating activities and rating performance which ESMA already publishes via its CENTRAL REPOSITORY database (CEREP).

<sup>120</sup> European Securities and Markets Authority, 'ESMA supervision of Credit Rating Agencies and Trade Repositories', Annual Report and Work Plan, 16 February 2015, 6-7. According to Article 23e of the CRA Regulation, ESMA will appoint an Independent Investigating Officer to investigate where it finds that there are 'serious indications of the possible existence of facts liable to constitute' an infringement relates to conflict of interest, organisational or operational requirements, to obstacles to the supervisory activities and to disclosure provisions.

<sup>121</sup> Gudula Deipenbrock, 'After 'CRA III – Achievements and Challenges from the Legal Perspective', paper presented at the 'Proceedings of the Workshop on Credit Rating Agencies - Implementation of Legislation', European Parliament, Directorate General for Internal Policies, Brussels, 18 March 2014. It is claimed that 'considerable progress has been made with a view to rating-directed regulation. However, the CRA III Regulation might not be considered to have played so far or play an important part in tackling the dysfunctions of the European credit rating sector' (at 11).

<sup>122</sup> European Securities and Markets Authority, 'ESMA's supervision of credit rating agencies and trade repositories', 5 February 2015, 6.

the different steps of the process followed or did not clearly allocate roles and responsibilities'.<sup>123</sup> Closer examination of the ESMA's supervisory duties leaves the impression that rating methodologies are not monitored effectively. ESMA has launched an ongoing discussion on the validation and review of CRAs' internal models in order to explore new investigation measures, such as 'discriminatory power', 'predictive power', 'historical robustness' and 'limited quantitative evidence'.<sup>124</sup> To enhance ratings accuracy, the Credit Rating Agencies Technical Committee provides support to ESMA by promoting supervisory convergence and technical standards concerning policy in the area of CRAs.<sup>125</sup>

However, Community regulations aim to reinforce the ESMA's power of supervision may clash with the CRAs' compliance procedures. The upshot is that CRAs can continue their activity largely unmonitored within the areas of conflicts of interest and market concentration. Indeed, it is instructive that ESMA has published data on the performance of CRAs while deploring the absence of clarity on the future obligation regarding structured finance instruments.<sup>126</sup> This means that CRA continue to respond to the incentives of the rating business with the result that they are driven mostly by changes in business cycle variables rather than changes in the characteristics of individual firms.<sup>127</sup> The internal control system of the CRAs should comply with ESMA monitoring measures in order to identify and eliminate conflicts of interest and to disclose to markets. In this context, ESMA supervisory actions are directed to ensure the independence of the CRAs' activities and to prevent potential collusive behaviour from influencing the quality of ratings.

## 6. *Concluding remarks*

Recent history shows too well that CRAs have not lived up to what may reasonably be

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<sup>123</sup> European Securities and Markets Authority (note 111) 14.

<sup>124</sup> European Securities and Markets Authority, 'Open Hearing on Discussion Paper on the Validation and Review of Credit Rating Agencies' Methodologies', 25 January 2016, ESMA/2016/96.

<sup>125</sup> European Securities and Markets Authority, 'Terms of Reference. Credit Rating Agencies Technical Committee (CRA TC)', 27 January 2016, ESMA/2016/219; 'A Common Approach to the CRA Regulation's Provisions for Encouraging the use of Smaller CRAs', 6 April 2017, ESMA33-9-158; 'ESMA's supervision of credit rating agencies, trade repositories and monitoring of third country central counterparties', 3 February 2017, ESMA80-1467488426-27, 38-39; 'Guidelines on the validation and review of Credit Rating Agencies' methodologies', 15 November 2016, ESMA/2016/1575.

<sup>126</sup> European Securities and Markets Authority, 'ESMA update on reporting structured finance instruments information under the CRA Regulation', 27 April 2016, available at <https://www.esma.europa.eu/press-news/esma-news/esma-update-reporting-structured-finance-instruments-information-under-cra>.

<sup>127</sup> European Securities and Markets Authority, 'Thematic Report. On fees charged by Credit Rating Agencies and Trade Repositories', 11 January 2018, 2. Specifically, it is observed that 'non-transparent price increases in the credit rating industry which do not seem based on costs, but are rather driven by the value of the product/service for the client that might have discriminatory consequences and prevent fair competition'.

expected of them. The existence of admitted conflicts of interests cannot just be shrugged aside. Moreover, there is some evidence that CRAs may use the threat of an unsolicited credit rating to pressurize firms into opting for a solicited rating.<sup>128</sup>

CRAs have acknowledged the existence of the issuer-pays conflict of interests and the more benign risk of error, but have typically downplayed their significance, stating that their reputations are far too valuable to the success of their businesses for them either to succumb to the biases inherent in the 'issuer-pays' revenue model or to issue inaccurate ratings.<sup>129</sup> Individual investors rely on the ratings because of their perceived authority, while institutional investors rely on them because of their market authority. The fact that financial products need to be labeled for ensuring substantial revenues to companies implies a high demand for CRAs. Further, the fact that financial firms need to be rated for gaining reputation in the securities markets means not only a pushed involvement of rating activities but also a qualified reliance on flawed assessment.<sup>130</sup> On this view, the frenetic growth in structured finance brought about not only a biased relationship with issuers but also a lucrative use of CRAs.<sup>131</sup>

What is crucial for the operation of the legal protection for investors is the soundness of CRAs' actions in interpreting disclosed information and assessing the creditworthiness of companies, thereby increasing market confidence. In other words, investors should be ensured of the appropriate level of information on which to make decisions. It is evident that some individual investors are unskilled and make poor decisions about risk even when they have obtained full information about the products. Essentially, adequacy of disclosure is a gauge to determine what an investor knew or should have known based on the information available to him.<sup>132</sup> Ratings have become the arbiter of any securities transaction as well as an essential reference for investors: the global financial markets have credit ratings hard-wired into them, and it seems difficult for regulators to push for changing the 'ratings game'.<sup>133</sup> The crux of matter is the accuracy and integrity of ratings since the CRAs maintain their

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<sup>128</sup> Patrick Van Roy (note 67) 24-25.

<sup>129</sup> Tim Wittenberg, 'Regulatory Evolution of the EU Credit Rating Agency Framework' (2015) 16(4) *European Business Organization Law Review*, 677.

<sup>130</sup> Peter Green and Jeremy Jennings-Mares, 'Demand That Gave Rise to Complexity' *Financial Times* (London, 4 July 2008).

<sup>131</sup> Gerard Caprio Jr., Asli Demirgüç-Kunt and Edward J. Kane, 'The 2007 Meltdown in Structured Securitization: Searching for Lessons, not Scapegoats' (2010) 25(1) *The World Bank Research Observer*, 132-133.

<sup>132</sup> Steven L. Schwarcz, 'Information Asymmetry and Information Failure: Disclosure Problems in Complex Financial Markets' in William Sun, Jim Stewart and David Pollard (eds), *Corporate Governance and the Global Financial Crisis* (Cambridge: CUP 2011) 95.

<sup>133</sup> Imad A Moosa, 'The regulation of credit rating agencies: A realistic view' (2017) 18(2) *Journal of Banking Regulation*, 180.



conflicted business models. Although CRAs provide valuable information in the financial system and are subject to considerable scrutiny they largely escape accountability.